Supreme Court, U.S.
FILED
MAR 17 1986
JOSEPH F. SPANIOL, JR.
CLERK

No. 85-1196 (5)

In the Supreme Court of the United States

OCTOBER TERM, 1985

CITY OF CHARLOTTESVILLE, VIRGINIA, PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION IN OPPOSITION

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

WILLIAM H. SATTERFIELD
General Counsel

JEROME M. FEIT
Solicitor

JOSHUA Z. ROKACH
Attorney
Federal Energy Regulatory Commission
Washington, D.C. 20426

16pp

QUESTION PRESENTED

Whether the Federal Energy Regulatory Commission acted within the lawful scope of its discretion in computing the tax component of two pipelines' rates by using the tax liability of the pipelines as if they had filed tax returns "standing alone," rather than focusing on "actual taxes paid" as reflected in the consolidated income tax return filed by the group of which the pipelines are members.

TABLE OF CONTENTS

Page

Opinions below 1

Jurisdiction 1

Statute involved 2

Statement 2

Argument 8

Conclusion 11

TABLE OF AUTHORITIES

Cases:

American Public Gas Ass'n v. *FPC*, 567 F.2d 1016, cert. denied, 435 U.S. 907 9

City of Charlottesville v. FERC, 661 F.2d 945 ..... 3, 5, 8

Colorado Interstate Gas v. *FPC*, 324 U.S. 581 8

Florida Gas Transmission Co., 47 F.P.C. 341 ..... 3, 5

FPC v. *United Gas Pipe Line Co.*, 386 U.S. 237 ..... 2, 6, 7, 8, 10

Greater Boston Television Corp. v. *FCC*, 444 F.2d 841, 403 U.S. 923 10

Permian Basin Area Rate Cases, 390 U.S. 747 8

Tenneco Oil Co. v. *FERC*, 571 F.2d 834, cert. dismissed, 439 U.S. 801 ..... 7, 9

Page

Statutes:

Natural Gas Act, 15 U.S.C. 717 *et seq.* :

15 U.S.C. 717c(a) 2

15 U.S.C. 717c(d) 2

15 U.S.C. 717c(e) 2

In the Supreme Court of the United States

OCTOBER TERM, 1985

No. 85-1196

CITY OF CHARLOTTESVILLE, VIRGINIA, PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-37a) is reported at 774 F.2d 1205. The opinion of the Federal Energy Regulatory Commission (Pet. App. 38a-98a) is reported at 23 F.E.R.C. ¶ 61,396 and on rehearing, 24 F.E.R.C. ¶ 61,258 (1983). A prior opinion of the court of appeals in this case is reported at 661 F.2d 945 (1981) and a prior opinion of the Commission is reported at 8 F.E.R.C. ¶ 61,002 (1979) and on rehearing 9 F.E.R.C. ¶ 61,355 (1979).

JURISDICTION

The judgment of the court of appeals was entered on October 18, 1985. A petition for rehearing en banc was denied on January 13, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTE INVOLVED

The relevant portions of the Natural Gas Act, 15 U.S.C. 717c(a), (d) and (e), are set out in the petition at 3-4.

STATEMENT

1. The Columbia Gas Transmission Company and the Columbia Gulf Transmission Company ("the Columbia pipelines"), which are subject to the jurisdiction of the Federal Energy Regulatory Commission, are subsidiaries of a public utility holding company which has other subsidiaries. The pipelines were the profit makers for the affiliated group in the years at issue while several gas exploration and development subsidiaries sustained losses. The Internal Revenue Code permits affiliated companies to file consolidated income tax returns. Under this procedure losses from unprofitable companies may be used to offset income from profitable affiliates so that the affiliated group's tax liability is reduced. In the Columbia group's consolidated tax returns, the losses of the gas exploration and development companies were used to offset some of the income from the Columbia pipelines, enabling the group to reduce its income taxes (Pet. App. 41a-42a).

The Natural Gas Act requires rates to be "just and reasonable" (15 U.S.C. 717c(a)). A pipeline's rates are set to cover the cost of the service they provide and "[n]ormally included as a cost of service is a proper allowance for taxes, including federal income taxes." *FPC* v. *United Gas Pipe Line Co.*, 386 U.S. 237, 243 (1967). In proposing rates, the Columbia pipelines determined the tax component of their cost of service as if they had not been part of an affiliated group and thus did not take into account the tax savings resulting from the filing of a consolidated tax return. They instead calculated the tax allowance component of their rates by applying the applicable statutory tax rate to their profits (Pet. App. 39a). Petitioner, a customer of the pipelines, challenged this method of calculating the appropriate

tax allowance. It alleged that the pipelines should share the tax savings resulting from the filing of a consolidated return by the affiliated group with their customers by "flowing through" some of the savings to ratepayers.

2. The Commission in 1979 ruled in favor of the Columbia pipelines. 8 F.E.R.C. ¶ 61,002. The Commission held that it was preferable to have the affiliated group retain the tax benefits generated by the gas exploration and development losses rather than flowing them through to the pipelines' customers because with the extra money the gas exploration and development companies could explore for more gas. The Commission held this to be a desirable activity as a matter of policy in an era of gas shortages. *Id.* at 61,008.

The District of Columbia Circuit reversed and remanded in 1981. *City of Charlottesville* v. *FERC*, 661 F.2d 945. The court held, contrary to petitioner's arguments, that the Commission had the authority to allocate tax savings from the filing of a consolidated return, either by sharing them with ratepayers, as the agency had done until 1972, or by having the group retain them, the Commission's policy following *Florida Gas Transmission Co.*, 47 F.P.C. 341 (1972), as long as the record supported the Commission's rationale (*id.* at 948). The court found, however, that the Commission's orders failed to provide reasons supporting its decision since there was no evidence that the Commission's approach would operate as an incentive for exploration (*id.* at 953-954). The court remanded the case to the Commission for further proceedings.

3. On remand, the Commission "reconsidered the policy question from the ground up" (Pet. App. 45a n.8). Although it again concluded that the pipelines' tax allowance should not be reduced because the affiliated group's taxes were reduced by matching the pipelines' profits with the gas

exploration and development companies' losses, it reached that conclusion "for considerably different reasons" (*ibid.*). The Commission developed a "stand-alone" method applicable to all the utilities it regulates in order to give effect to the "benefits/burdens" principle that underlies its ratemaking methods. Under the benefits/burdens principle, the Commission attempts "to allocate costs to the group of ratepayers in question on the basis of a causal link between the service the company provides them and the expenses the company reports" (Pet. App. 46a). In applying that benefits/burdens principle in determining the appropriate tax allowance for a pipeline, the Commission explained, it analyzes deductions to determine whether the expense was incurred to provide service to the pipeline's customers.[1]

Applying the stand-alone method to the facts of the case, the Commission found that the pipelines' customers had not contributed to the gas exploration and development expenses that generated the losses on the group's consolidated tax return. Therefore, "the requisite causal link between the pipelines' ratepayers and the expense incurred is missing. * * * Accordingly, none of the expenses of the gas development companies were included in the pipelines' cost of services. Because this is so, none of the deductions * * * should be allocated to the pipelines' ratepayers." Pet. App. 54a. Therefore, the Commission concluded that the tax component of the Columbia pipelines' rates should not be reduced to reflect the tax savings produced by combining the gas exploration and development companies' losses with the pipelines' profits in a consolidated tax return.

---

[1]The Commission stated that its "stand-alone policy * * * analyzes each of the deductions used to reduce the group's tax liability to determine the deductions for which each service is responsible. It then allocates to the jurisdictional service those deductions which were generated by expenses incurred in providing that service. * * * In this way the tax allowance will reflect the profit the ratepayers contribute to the group's consolidated taxable income." Pet. App. 51a-52a.

The Commission also specifically responded to the approach suggested by petitioner, an approach based on the effective rate of taxes actually paid by members of the group to which the pipelines belonged. Petitioner's "actual taxes paid" method was rejected because it conflicts with the benefits/burdens principle underlying the Commission's ratemaking methods since the actual taxes paid approach "focuses solely on the total tax liability and the aggregate reduction [and] is oblivious to how that liability and reduction came about" (Pet. App. 55a).[2]

4. The court of appeals affirmed (Pet. App. 1a-37a). As did the panel that reviewed the Commission's first decision in this case (661 F.2d at 952 n.38), the court rejected petitioner's claim that the Commission had no authority to calculate a tax allowance except on the basis of "actual taxes paid" (Pet. App. 15a). The court of appeals instead found that this Court and others have permitted the Commission to calculate current tax costs on the basis of area-wide or nationwide averages or on possible future payments. The court concluded that "the imprecision of the 'actual taxes paid' formulation is exceeded only by the name

---

[2]Because the Commission had used the actual taxes paid method in the 1940s and 1950s and had gradually moved away from it over time (Pet. App. 55a), the Commission explained in detail the reasons why it had changed its approach. One reason for the change in ratemaking methods was a change in "the structure of the industry" caused by increasing diversification (*id.* at 57a). In response, the Commission has tried to regulate each pipeline "as an 'independent entity' so that it is 'considered as nearly as possible on its own merits and not on those of its affiliates' " (*id.* at 59a, quoting *Florida Gas Transmission Co.*, 47 F.P.C. at 363). Also leading to change in ratemaking methods were changes in the tax laws, particularly rules permitting accelerated depreciation for tax purposes (Pet. App. 67a-68a). The Commission had not permitted the use of accelerated depreciation for ratemaking purposes, but had instead followed a normalization approach, so that the depreciation amounts on pipelines' income tax returns and the depreciation amounts used to set rates were quite different.

of the Holy Roman Empire: two out of the three words are wrong. Taxes, yes. But not necessarily *actual* taxes, since inexact estimations are often allowed * * *. And not necessarily taxes *paid,* since tax liability incurred by current activities but in fact not paid currently can be charged to present ratepayers * * *." *Id.* at 19a-20a (emphasis in original).

The court rejected petitioner's claim that this Court's decision in *FPC* v. *United Gas Pipe Line Co.,* 386 U.S. 237 (1967), requires the use of the actual taxes paid method.[3] The holding in that case, the court stated, was that the Commission was *permitted* to use the actual taxes paid method. In reaching that conclusion this Court rejected the argument that a pipeline could include a tax allowance in its rates "even if on a consolidated basis system losses exceed system gains and neither the affiliated group nor any member in it has any tax liability," describing this as "an untenable position" (386 U.S. at 243-244).[4] The Court thus implied that the actual taxes paid approach is required. Those statements were dicta, the court of appeals concluded

---

[3]The method actually used by the Commission in that case involved first setting off profits and losses of all the unregulated companies filing a consolidated return with a pipeline. If there was a net profit on the part of the unregulated companies, then the pipeline's tax allowance would be based on the applicable statutory tax rate, the approach followed here. But if there was a net loss, then the pipeline's tax allowance was reduced. 386 U.S. at 241-242 & n.2.

[4]The Court described a tax allowance for a pipeline when a consolidated group pays no tax as a "hypothetical tax expense" and stated that "when the out-of-pocket tax cost of the regulated affiliate is reduced, there is an immediate confrontation with the ratemaking principle that limits cost of service to expenses actually incurred" (386 U.S. at 244). The Court stated that prior cases supported the conclusion that it is "the power and the duty of the Commission to limit cost of service to real expenses" (*id.* at 245).

(Pet. App. 22a).[5] The holding in *United* was not that an actual taxes paid approach is required but that it is not beyond the Commission's authority to adopt that approach (*ibid.*).

The court of appeals concluded that the only difference between this case and other cases that departed from an actual taxes paid approach is that the "theoretical tax liability for the pipeline's net income may never be reflected on *anyone's* actual tax bill, since it may be offset by losses of the parent and other affiliates" (Pet. App. 20a). But, the court explained, that made no real difference. If the affiliated group had not used the gas exploration and development companies' losses to offset the pipelines' income, the gas exploration and development companies might have carried them forward or backward to set off profits. Or the group might have decided to affiliate with profitable companies other than the pipelines in order to use the gas exploration and development companies' losses to reduce tax liabilities.[6] Therefore, the court concluded, it is "reasonable to regard as no less real an economic detriment than cash payment of tax assessments, the consumption of otherwise usable tax losses to forestall those assessments" (*id.* at 21a). The court held that the Commission's stand-alone

---

[5]The panel of the court of appeals that first reviewed the Commission decision in this case also recognized that the Court's statements in *United* were dicta. It stated: "The Commission is not obligated to follow any particular formula for the apportionment of consolidated tax savings. The *United* ruling allowed flow-through to ratepayers but did not mandate it." 661 F.2d at 952 (footnote omitted). Similarly, in *Tenneco Oil Co.* v. *FERC*, 571 F.2d 834, 843 (5th Cir. 1978), the court recognized that this Court's *United* decision "contained a phrase referring to 'the power and the duty of the Commission to limit cost of service to real expenses,' * * * but the use of the word 'duty' was dictum."

[6]The court added that "[i]n an era when enterprises are frequently the objects of acquisition or merger because of their temporary tax-loss benefits, such a prospect is far from fanciful." Pet. App. 22a-23a.

method, while not "the only rational or permissible" method (*ibid.*), "is reasonable enough to survive our highly deferential review" (*id.* at 23a).

ARGUMENT

The court of appeals correctly decided that the Commission did not exceed the scope of its discretion by adopting its "stand-alone" method and applying it in this case. Petitioner does not allege that there is a conflict in the circuits, but instead argues that review is warranted because the Commission's use of the stand-alone method is contrary to this Court's decision in *FPC* v. *United Gas Pipe Line Co.*, 386 U.S. 237 (1967), which in petitioner's view mandates use of the actual taxes paid method. There is no merit to that argument. Accordingly, further review is not warranted.

The Commission has broad discretion in determining what rates are just and reasonable. Under the Natural Gas Act, this Court has stated, "review is limited to keeping the Commission within the bounds which Congress created. When Congress * * * fails to provide a formula for the Commission to follow, courts are not warranted in rejecting the one which the Commission employs unless it plainly contravenes the statutory scheme of regulation." *Colorado Interstate Gas* v. *FPC*, 324 U.S. 581, 589 (1945). Thus, in reviewing rate orders, a reviewing court "must determine whether the Commission's order, viewed in light of the relevant facts and of the Commission's broad regulatory duties, abused or exceeded its authority." *Permian Basin Area Rate Cases*, 390 U.S. 747, 791 (1968). There is no contention here that Congress has provided a formula for the Commission to use in determining whether a tax allowance is just and reasonable.[7] Nor can it persuasively be

---

[7]As the court of appeals noted in its first opinion in this case, "[t]he Natural Gas Act fails to prescribe specific standards for ratemakers to follow. In fact, the only requirement is that a rate be 'just and reasonable.' " 661 F.2d at 949 (footnote omitted).

argued that the Commission's stand-alone method contravenes the statutory scheme. The Commission explained in detail why it has determined that that method produces just and reasonable rates. It also explained why it has decided to use the stand-alone method rather than the actual taxes paid method that it previously used. As the court of appeals concluded, while the stand-alone method is not the only rational or permissible approach the Commission could mandate, it is a reasonable method. Therefore, the Commission has not exceeded its authority.

Petitioner bases its argument that review is warranted entirely on its contention that this Court's *United* decision mandates use of the actual taxes paid approach.[8] Petitioner states that the court of appeals concluded that "the *United* decision has no force in a pipeline rate proceeding" (Pet. 18) and asks the Court to grant its petition in order to resolve a "disagreement regarding the continuing vitality of the *United* decision" (Pet. 22). There is no disagreement about the vitality of the *United* decision. Petitioner fails to acknowledge that an agency may adopt an approach that

---

[8]Petitioner also argues (Pet. 22-24) that the appellate court decisions cited by the court of appeals in this case do not compel approval of the approach followed by the Commission here. Those cases, such as *Tenneco Oil Co.* v. *FERC*, 571 F.2d 834 (5th Cir.), cert. dismissed, 439 U.S. 801 (1978), and *American Public Gas Ass'n* v. *FPC*, 567 F.2d 1016 (D.C. Cir. 1977), cert. denied, 435 U.S. 907 (1978), illustrate that on other occasions the Commission has not followed an actual taxes paid approach in various contexts and that courts have approved its actions. As the court of appeals recognized (Pet. App. 20a-21a), the Commission's action here differs somewhat from the actions it took in those cases. But those cases show, contrary to petitioner's claim, that there is no rule that an actual taxes paid approach is mandatory. Petitioner does not suggest that there is a conflict between the present case and the decisions in *Tenneco* and *American Public Gas Association*, as of course it cannot. An arguable conflict would have arisen only if, contrary to the other appellate court decisions cited by the court here, the court of appeals had concluded that the Commission was barred from using its stand-alone approach.

survives judicial review and then on further analysis adopt a different approach that is also permissible.[9] That is what happened here.

In *United,* a pipeline claimed that the Commission had exceeded the limits of its jurisdiction by considering the losses of a nonregulated affiliate in determining the pipeline's tax allowance. The court of appeals in that case had determined, as the pipeline argued, that the Commission had exceeded the limits imposed by Congress by using an actual taxes paid approach since in doing so it was taking into account the tax losses of a company that was not subject to its jurisdiction. 386 U.S. at 239. The Court reversed, holding that "we cannot say that the method the Commission chose to allocate the tax liability among the group members was erroneous or contrary to its statutory authority" (*id.* at 245) and hence that the Commission "did not exceed the powers granted to it by Congress" (*id.* at 243). In reaching that conclusion the Court of course reviewed the substance of the approach used by the Commission. In commenting on that method the Court made the statements relied upon by petitioner (see Pet. 14-15). But, as the court of appeals recognized, those statements were dicta to the extent that they may be read as more than a justification for the Commission's choice of regulatory policy. In approving the use of an actual taxes paid approach, the Court did not mandate the use of that method. It merely held that the Commission had not exceeded the limits of its

---

[9]The first panel reviewing the Commission's decision in this case noted that the "fact that a change in policy has occurred is no basis, by itself, for viewing the Commission's decision with disfavor." 661 F.2d at 951 n.35. Rather, an agency changing its policy is required to " 'supply a reasoned analysis indicating that prior policies and standards are being deliberately changed.' " *Ibid.*, quoting *Greater Boston Television Corp.* v. *FCC,* 444 F.2d 841, 852 (D.C. Cir. 1970), cert. denied, 403 U.S. 923 (1971). As we have shown, the Commission recognized that it was changing course here and explained its reasons for doing so in detail.

statutory authority by considering the losses of companies that were not subject to its jurisdiction. It does not follow, as petitioner would have it, that because the Court held in *United* that the Commission *may* consider the losses of companies not subject to its jurisdiction, the Commission is *required* to consider the losses of affiliated companies. Nothing in the Natural Gas Act requires such a result. There is therefore no conflict between the court of appeals' decision and this Court's decision in *United*.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

CHARLES FRIED
Solicitor General

WILLIAM H. SATTERFIELD
General Counsel

JEROME M. FEIT
Solicitor

JOSHUA Z. ROKACH
Attorney

MARCH 1986

DOJ-1986-03